COMMONWEALTH OF MASSACHUSETTS

DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Massachusetts Electric Company and Nantucket Electric Company "Now Is the Time to Choose" Program	)	D.T.E. 03-123

COMMENTS OF DIRECT ENERGY

Direct Energy ("DE"), a subsidiary of Centrica North America, is pleased to provide these comments on the proposal of Massachusetts Electric Company and Nantucket Electric Company (collectively "the Companies") to implement a program it has entitled "Now Is the Time to Choose." As described in the Companies' filing, the proposal would have two main components. First, the proposal calls for an educational and promotional campaign designed to alert Standard Offer customers "informing them that the competitive market may provide better alternative electricity supply than continuing on Standard Offer Service." Proposal at 3. Second, the program would maintain the Standard Offer service fuel adjustment ("SOSFA") for both companies at no less than the current 1.424 cents per kWh throughout the remainder of the transition period, which will end February 28, 2005. The SOSFA would be allowed to increase in accordance with the Companies' applicable Standard Offer service tariffs, but would not be allowed to fall below the current level. Proposal at 3-5.

In general, DE fully supports the Department's ongoing efforts to make the Massachusetts retail markets more competitive. The MECo proposal regarding the SOSFA, however, will not make the retail market in Massachusetts more competitive in a sustainable

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way, and could result in no meaningful choices from competitive suppliers to residential and small business customers.[1]

DE's comments in this proceeding are directed primarily at the effect the proposal would have on the "mass market," namely residential and small business customers. This is the market segment with which DE is most familiar, and the company takes no position at this time regarding the impact of the program on the medium and large commercial and industrial customer classes. While DE is confident that its legislative proposal for further restructuring in anticipation of the expiration of the Standard Offer, (which proposal is discussed further below), would inure to the benefit of all customer classes, the retail suppliers serving them, and the utilities themselves, the immediate impact of the MECo proposal on the commercial and industrial market is beyond the scope of these comments.

The MECo proposal maintains that current pricing conditions are such that taking service from a competitive supplier may be a more attractive option than it has been for the first five years of the transition period. The basis for this contention is that, for the first time since the Restructuring Act became effective, the total Standard Offer price (the base price plus the SOSFA) is higher than the Default Service price and is expected to remain higher for at least several months. In addition to alerting Standard Offer customers to these conditions, the proposal also attempts to ensure that the Standard Offer price will not fall back below the Default Service price by setting the current SOSFA, 1.424 cents per kWh, as a floor below which the SOSFA could not fall. The SOSFA could increase due to higher fuel prices, but it could not decrease below the 1.424 cent floor.

Keeping the Standard Offer price at this level in order to make the Massachusetts residential and small business markets more attractive to competitive suppliers is a potential

[1] DE takes no position at this time with respect to the customer education portion of the MECo proposal.

short-term solution to a much larger problem that the proposal ignores. If one could be certain that "below market" Standard Offer prices were the only impediment to the development of a robust competitive market for residential and small business customers, then ensuring that the Standard Offer price did not undercut the true market price of electricity would be a worthy regulatory goal. In Massachusetts, however, there are clearly more fundamental flaws in the market structure that this proposal will not address.

These flaws are revealed not merely by examining the extent to which competitive suppliers have won customers away from Standard Offer service. One must also examine the interplay between competitive supply and <u>Default Service</u> to get a full sense of the state of the retail market in Massachusetts. The DOER's latest migration data for the MECo service territory show that there are about 650,000 non-low income residential customers on Standard Offer service and only about 7,800 customers taking service from competitive suppliers. However, there are also over 320,000 residential customers on <u>Default Service</u> in the MECo service territory. Default Service is required by statute to reflect the market price for electricity and is, indeed, competitively procured directly from the wholesale market. If competitive suppliers cannot compete with either "below market" Standard Offer service <u>or</u> "market priced" Default Service, there must be impediments to the development of a robust market for residential and small business customers that tinkering with the Standard Offer price will not address.

DE believes that these impediments to competition are created by a market structure in which the regulated utility acts as both the distribution company and a retail marketer offering as many as three different products to the retail market while recovering important components of retail service through the delivery rate.[2] As Centrica North America and others pointed out to

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[2] With the addition of a "green" option, MECo now offers three retail products: Standard Offer service, regular Default Service, and "green" Default Service.

the Department in comments filed in D.T.E. 02-40 in 2002, the "generation" charge against which non-utility suppliers compete represents only the wholesale electricity commodity costs incurred by the utility. All of the other components of retail service (e.g., billing, customer service, and marketing) are collected through delivery charges and paid by <u>all</u> customers, even those taking service from a competitive supplier. In order to win customers away from utility service, competitive suppliers must provide the commodity plus all of the other components of retail service at a price less than what the utility pays for the commodity. Competitive suppliers must compensate for the fact that their customers pay twice for those retail services: once to the competitive supplier and again to the utility through the distribution rate.

One can create the ***temporary*** appearance of competition in such a market by increasing the price of the utility offering until the utility's advantage of collecting for retail services in its unavoidable distribution rate is neutralized. (MECo's proposal attempts to do just this in the context of Standard Offer service.) But this approach does not help customers, who continue to pay twice for retail services (with, in the case of MECo's proposal, slightly more "headroom" as an incentive for competitive suppliers to support this short term proposal.).

One can also attempt to identify and separate from the distribution rates those costs that the utility can avoid when a customer switches to a competitive supplier. This approach has certain merits, and Centrica North America supported such an undertaking in its comments in D.T.E. 02-40. Even this worthy exercise, however, leaves the utility in the position of being an active competitor in the retail market in which its primary function should be neutral provider of safe and reliable distribution services. Based on our experiences in the United Kingdom, Texas and other developing electricity and natural gas markets, as long as the utility remains a competitive retailer, it has an incentive to maintain its monopoly in the retail services on which it earns a return, and to cross-subsidize those retail services through the delivery charges to the maximum extent possible.

DE believes that the only way to address this fundamental flaw in the retail market is to structurally separate the true distribution functions of the utility from the retail services that should be provided by the competitive market, and that any regulatory attempt at unbundling these costs without this legislative separation will fail due to the natural incentive for the utility to keep as many commodity related costs in the distribution rates as possible. Centrica North America readily acknowledged in D.T.E. 02-40 that this solution is very likely beyond the Department's statutory authority. Thus, DE has now created a legislative proposal that would amend G.L. c. 164 to require that utilities file plans for the separation of their existing companies into two separate entities: a regulated distribution company, the sole function of which would be to provide safe and reliable delivery services to their customers, and a retail affiliate, which would compete against non-utility suppliers in a restructured retail market that would begin operation on March 1, 2005. A memorandum describing the DE legislative proposal in more detail is attached to these comments.

The DE plan would create a retail market in which the incumbent utility no longer has a structural advantage based on its monopoly control of certain retail functions. It would create opportunities for innovation by new suppliers who would be making a long-term commitment to the Massachusetts market, rather than looking for a temporary solution to the lack of residential migration to competitive supply, based on a temporary pricing anomaly. DE's proposal is also designed to allow utilities that have no interest in participating in a more structurally sound retail market to exit the business in a manner that would protect both their customers and their shareholders. The MECo proposal offers no such advantages. It would only mask the infirmities in the retail market structure for a scant 14 months until the expiration of the Standard Offer reveals that nothing has really changed.

DE's concern regarding the MECo proposal is that the proposal would suggest that all that is required to solve the problems in this market is to enact the MECo plan. However, this would mean that upon the expiration of Standard Offer on March 1, 2005, once again, residential marketers are still competing against the same Default Service structure that contains the same "cross subsidy" problem referred to above. This continues to create a disincentive to any consumer contemplating a move to competitive supply after March 1, 2005, as the consumer would have to really pay twice for the retail costs of providing commodity service if they left Default Service – once, through the utility's distribution rates, and again through the competitive supplier's commodity rates, as mentioned above.

The MECo proposal suggests that if competitive suppliers to smaller customers generally cannot compete with today's Default Service rates (DE agrees this problem exists, due to the "cross-subsidy" referred to above), these suppliers are more likely able to compete with the proposed SO rates as described in the MECo proposal. Thus the proposal assumes that any rate a competitive supplier were to offer small customers under the MECo plan would be higher than the Default Service rate (though presumably lower than the proposed MECo SO rate). In that case, upon the expiration of SO on March 1, 2005, the competitive offers just described would now be higher than the only utility offering available to consumers after March 1, 2005. Consumers would wind up simply migrating back to Default Service after March 1, 2005.

DE opposes this proposal because we feel it is simply a temporary "mollification" to competitive suppliers who understandably cannot compete with a cross-subsidized DS (or SO) rate, and that after March 1, 2005, the current situation of few Default Service customers being on competitive supply will simply repeat itself. The only way to prevent this rebound effect would be to restructure the retail market to create real competition, eliminating the regulated distribution company as a direct competitor in the market. This would produce true, sustainable choices to consumers and eliminate the “unlevel” playing field that enables the utility to maintain monopoly control over consumers’ commodity service through a cross subsidy of their commodity rates.

Even under the proposed Standard Offer rates, there is no assurance that the 650,000 residential and 67,000 small business Standard Offer customers in MECo’s service territory will have meaningful competitive opportunities in the 14 months that remain of the transition period. In DE’s view, competitive opportunities would be meaningful only if they offered more than temporary relief from the overall market structure infirmities. DE is concerned that the MECo proposal would create the illusion of competition while maintaining a structure that favors monopoly control of the residential and small business customers by the incumbent utility.

Other states have tried similar schemes to stimulate the retail mass market, and the Companies make no attempt to explain why their proposal will succeed where others have failed. On the other hand, Texas has built a sustainable market structure based on the principles described above and is beginning to see meaningful competitive choice.

CONCLUSION

The Companies’ proposal distracts stakeholders from problems inherent in the cross subsidy of commodity rates, by attempting a temporary mollification of competitive supplier concerns about the cross-subsidy problem. Under this proposal, these problems will resurface on March 1, 2005, when Standard Offer expires. The proposal seeks to drive residential and small business customers away from Standard Offer by creating a temporary pricing anomaly, without addressing the fundamental market flaws that will continue to retard the development of sustainable choices for consumers after the Standard Offer expires. DE urges the Department to reject the proposal as it would be applied to the residential and small business customer classes. DE believes that our legislative proposal will solve the problems creating a lack of competitive choices to the bulk of Massachusetts' smaller electric customers.

Respectfully submitted,

DIRECT ENERGY

By its counsel:

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